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# From Paper to Electronic Order: The Digitalization of the Check in the USA

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Penn State Journal of Law and International Affairs, Vol. 4(1), 2015.

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## FROM PAPER TO ELECTRONIC ORDER: THE DIGITALIZATION OF THE CHECK IN THE USA\*

*Benjamin Geva\*\**

### INTRODUCTION

A check is a paper instrument embodying an unconditional order in writing. It is signed by a drawer and addressed to a drawee bank with which the drawer typically maintains an account. The check instructs the bank<sup>1</sup> to make payment on demand to, or to the order of, a designated payee, or to the bearer.<sup>2</sup> The person to whom a check is payable and who is in the possession of the check is its holder.<sup>3</sup> A check is issued when the drawer delivers it to the first holder,<sup>4</sup> who is either the payee of a check payable to order or the first bearer of a check

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\*\* Professor of Law, Osgoode Hall York University, and Counsel, Torys LLP, Toronto, Canada. The article substantially updates and expands on Benjamin Geva, *Recent International Developments in the Law of Negotiable Instruments and Payment and Settlement Systems*, 42 TEX. INT'L L.J. 685, 687-99 (2007) and is a sequel to B. Geva, *Is Death of the Paper Cheque upon Us? The Electronic Presentment and Deposit of Cheques in Canada*, 30 B.F.L.R. 113 (2014). I am grateful to Joe Wahba of the 2016 graduating class of Osgoode Hall Law School for his research assistance. All errors are mine.

<sup>1</sup> “Bank” is broadly defined to include any person “engaged in the business of banking.” See U.C.C. § 1-201(b)(4) (2014). Undoubtedly, any institution that either takes deposit and/or offers account services falls into this definition. Technically, however, the account relationship requirement is not spelled out by statute.

<sup>2</sup> U.C.C. §§ 3-104(f), 3-103(a)(8) (2014).

<sup>3</sup> U.C.C. § 1-201(b)(21)(B) (2014).

<sup>4</sup> See U.C.C. § 3-105(a) (2014) (defining “issue” as “the first delivery of an instrument by the maker or drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person.”). Issue to a non-holder is less common and is outside the scope of the present discussion.

payable to bearer. Once issued, a check may circulate from hand to hand by negotiation, namely by its delivery from one holder to another. In the case of a check payable to order, negotiation consists of delivery accompanied by the signature of the holder, called “indorsement.”<sup>5</sup> To obtain payment, the last holder is to have the check physically presented to the drawee bank.<sup>6</sup>

Nowadays, there is very little circulation of checks, so presentment is usually made by or on behalf of the first holder. Regardless, a holder typically will not present the check to the drawee bank in person. Rather, the holder is likely to have the check deposited with and collected by a depositary bank with which the holder maintains an account. The depositary bank will then either present the check directly to the drawee bank, or will negotiate it to an intermediary bank. There may be one or more negotiations with one or more intermediary banks. The last intermediary bank will present the check for payment to the drawee. In that process, all banks other than the drawee, namely the depositary bank and each intermediary bank, are collecting banks, the drawee bank is the payor bank, and the collecting bank that presents the check for payment to the drawee bank is the presenting bank.<sup>7</sup>

The normal life cycle of a check thus entails a series of physical deliveries of the piece of paper embodying it. First, the check is physically issued by the drawer to the first holder. Second, there may be one or more physical negotiations outside the banking system. Third, there is the physical delivery of the check by the holder to the depositary bank. Fourth, there may be one or more deliveries of the check to intermediary bank(s). Fifth, the process concludes with a physical presentment of the check to the drawee. Following payment, there is possibly a sixth and post-concluding stage in which the cancelled check is delivered by the payor bank to the drawer, together with the periodic statement containing it. Alternatively, where the

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<sup>5</sup> U.C.C. §§ 3-201(a), 3-201(b), 3-204 (2014).

<sup>6</sup> This point is implied, though not specifically provided for, in U.C.C. § 3-501(b)(2) (2014), which addresses the exhibition of the check to, and its handling by, the drawee.

<sup>7</sup> For applicable definitions, see U.C.C. §§ 4-104, 4-105 (2014).

drawee dishonors the check, the check is returned in a reversed itinerary.

Modern law facilitates variations by agreement. On occasion, it may further provide for the impact of such variations on third parties not privy to agreed variations. First, a check may be given as a source of information to be used to initiate a one-time electronic fund transfer, often described as an “electronic check.” Second, a check may be remotely created. Third, a check may be presented for payment electronically. Fourth, a check may be negotiated to a collecting bank, whether by its customer the holder or another collecting bank, by means of electronic transmission. At the same time, a practice of electronic negotiation other than to banks has not developed so that no provision for such electronic transmission has been made. Finally, there is the possibility that a payment order will be issued electronically and will not be embodied in a piece of paper at its inception.

As a source of information, a check may be given to the payee with the authority to convert it to an electronic image. A remotely created check is drawn by the payee, as an agent of the drawer, on the basis of information provided by the drawer to the payee, typically over the telephone. This practice is more concerned with the remote creation of a paper check rather than with its dispensation and thus is not addressed in this article. Both electronic negotiation and presentment involve check truncation, namely a procedure in which the physical movement of checks is curtailed or eliminated, being replaced, in whole or in part, by electronic transmission of information.<sup>8</sup> Issued and processed electronically, and thus not being “written,” an electronic payment order is not an “order” under U.C.C. Section 3-103(a)(8). As such it is not a “draft” under Section 3-104(e) and thus not a “check” under Section 3-104(f). However, an electronic payment is a functional equivalent for a check. Being the logical

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<sup>8</sup> See, e.g., the definitions listed in COMMITTEE ON PAYMENT AND SETTLEMENTS, A GLOSSARY OF TERMS USED IN PAYMENTS AND SETTLEMENT SYSTEMS (2003). For similar definitions focusing on the conversion of data on a paper to an electronic image, see *Wells Fargo Bank v. Burrier (In re Burrier)*, 399 B.R. 258, 264 (Bankr. D. Co. 2008).

conclusion of the check electronification process, this method of payment is addressed in this article.

This article explores the various stages in the check payment in which electronic transmission has replaced physical delivery. Part I discusses converting the check into an electronic entry at a point of sale of goods and services. Part II addresses the electronic presentment of a check. Part III deals with the possible conversion of the check from paper to electronic, and vice versa, within the interbank check collection system. Interbank exchange of check images is the subject of Part IV. Part V addresses the electronic order that operates like a check but that has never been in a paper format. This article examines the applicable provisions of the Uniform Commercial Code, U.S. federal regulations and legislation, and proposals for reform, as well as private-sector norms. Having explored existing norms and proposals, the article concludes with a plea for advancing the process of the complete electronification of the check and its collection process as well as for the establishment of a comprehensive legal scheme to govern such matters

## I. THE SO-CALLED “ELECTRONIC CHECK”

On occasion, a check may not be “issued” with the view of giving the payee the rights to enforce payment on it in discharge of the underlying obligation.<sup>9</sup> Rather, contrary to the usual presumption of conditional payment by check,<sup>10</sup> a check may be given to the payee merely as a source of information to be used to initiate a one-time electronic fund transfer from the drawer’s account in payment of the obligation. The check is then used as a source document for the drawer’s routing number and account number, as well as the check’s serial number, and the sum payable. In effect, the check is thus converted to a single debit entry, which is then input into the Automated Clearing House (ACH) Network. This arrangement is

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<sup>9</sup> “Issue” is defined as “the first delivery of an instrument by the maker or drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person.” U.C.C. Section 3-105(a) (2015).

<sup>10</sup> For an explanation of this presumption, see U.C.C. Section 3-310(b) (2015) (“[u]nless otherwise agreed . . . if . . . an uncertified check is taken for an obligation, the obligation is suspended . . . until dishonor of the check or until [the check] is paid or certified”).

particularly common in consumer transactions. Thus, where the check is mailed to the payee-merchant, the check is converted to an ARC—Accounts Receivables Entry. Similarly, where the check is given to the payee-merchant in a face-to-face transaction, the check is converted to a Point-of-Purchase (POP) Entry.<sup>11</sup> Once converted, the check itself is voided; practically speaking in a face-to-face transaction the voided check is typically returned to the consumer-drawer.<sup>12</sup>

The electronic image created by the merchant, usually at the point-of-sale, is often colloquially referred to as an “electronic check.” However, as will be further discussed below, the term may have been “hijacked” by the Federal Reserve Board to denote the digital image of a check. In any event, in the present context, “electronic check” is a misnomer; rather, what is generated, is an ACH debit entry. Payment is thus not governed by U.C.C. Articles three and four, but instead is covered by Regulation E, issued by the Federal Reserve Board, which governs consumer electronic fund transfers.<sup>13</sup> Regulation E requires the merchant to “provide a notice that the transaction will or may be processed as an EFT<sup>14</sup> and obtain a consumer’s authorization for each transfer.”<sup>15</sup>

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<sup>11</sup> Related entries are TEL and WEB, respectively, ACH entries made on the basis of payment instructions made by phone-calls and over the Internet rather than at a physical point of sale as the POP entry.

<sup>12</sup> See, e.g., NACHA OPERATING RULES AND GUIDELINES AND ACH OPERATING RULES, A COMPLETE GUIDE TO THE RULES GOVERNING THE ACH NETWORK, Sections 3.7 and 3.8 (2014) (providing a brief explanation of the “ACH Primer” preceding National Automated Clearing House Association (NACHA) Operating Rules) [hereinafter NACHA OPERATING GUIDELINES].

<sup>13</sup> Electronic Fund Transfers (Regulation E), 12 C.F.R. § 205(c) (2015) (Regulation E does not cover “[a]ny transfer of funds originated by check.”). The theory of the check conversion is, however, that the transfer is initiated by the converted debit entry, rather than the check that has been used as a mere source of information.

<sup>14</sup> EFT stands for Electronic Fund Transfer.

<sup>15</sup> 12 C.F.R. § 205.3(b)(2). See also generally 12 C.F.R. § 205 (Briefly stated, the underlying theory of the requirement is that conversion may change the consumer’s position, e.g., insofar as payment is likely to be speedier and the cancelled check will not prove payment.).



## II. ELECTRONIC CHECK PRESENTMENT

Electronic presentment is provided for by U.C.C. Section 4-110. Thereunder, the presentment of a check may be made pursuant to an interbank agreement for presentment. An “agreement for electronic presentment” can be in the form of an agreement, clearing-house rule, or Federal Reserve regulation or operating circular.<sup>16</sup> The agreement is to provide “that presentment . . . may be made by the transmission of an image of [a check] or information describing [it] . . . rather than delivery of the [check] itself.” The transmission of the image or information constitutes a “presentment notice”; its receipt is the actual presentment. Other elements that may be covered by the agreement for electronic presentment are “procedures governing retention . . . payment, dishonor and other matters.” Arguably, return procedures fall within the scope of the agreement.

An interbank voluntary agreement may be either bilateral or multilateral.<sup>17</sup> In any event, per the language quoted above, an “agreement for electronic presentment” under U.C.C. Section 4-110 may not be entirely consensual. This is, however, consistent with the general principle under which “Federal Reserve regulations and operating circulars, clearing-house rules, and the like have the effect of

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<sup>16</sup> See, e.g., Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire (Regulation J), 12 C.F.R. § 210 (2015) (defining “item” in Section 210.2(i) to include “electronic item,” such as an electronic image of a check or any other paper item). See also FEDERAL RESERVE FINANCIAL SERVICES FEDERAL RESERVE BANKS, OPERATING CIRCULAR NO. 3: COLLECTION OF CASH ITEMS AND RETURNED CHECKS (2012) (electronic access to Reserve Bank’s Services is governed by Section 5 and Appendices E (MICR presentment services), E1 (truncation service), E2 (MICR presentment plus service), and E3 basic (MICR presentment service)).

<sup>17</sup> One such multilateral agreement is under the rules of the check truncation program of NACHA for electronic images of truncated checks input to the ACH Network. See NACHA OPERATING GUIDELINES, *supra* note 12, at § 1(2)(c) (check truncated items input to the ACH Network are TRC/TRX entries referred to as a category of Payment Applications which are governed by Art. 10 of the NACHA Operating Rules). See also NACHA OPERATING GUIDELINES, *supra* note 12, at ACH Primer § C(3). For bulk electronic payments processed through the ACH Network and for NACHA, as well as for NACHA Operating Rules and Guidelines, see Section 5 *infra*.

agreements . . . whether or not specifically assented to by all parties interested in items handled.”<sup>18</sup>

### III. THE “SUBSTITUTE CHECK”

Electronic negotiation to a collecting bank is the most elaborate statutory and regulatory scheme. The scheme is governed by the Check Clearing for the 21<sup>st</sup> Century Act (“Check 21 Act”)<sup>19</sup> and implemented by Regulation CC subpart D.<sup>20</sup> In essence, the Check 21 Act authorizes a collecting bank to create a substitute paper check<sup>21</sup> for further negotiation or presentment. Having agreed to receive a check in an electronic form, a collecting bank that receives the electronic check image or information is authorized under the Check 21 Act to create a substitute check. Upon compliance with specified requirements, the substitute check becomes “the legal equivalent of the original check for all purposes.”<sup>22</sup> The Check 21 Act further includes warranty and indemnity provisions, as well as expedited re-credit procedures, designed to protect substitute check recipients.<sup>23</sup>

In practice, the creation of a substitute check by a collecting bank is predicated upon the existence of two preconditions. First, the creating bank must receive a transmission of an image of the original check, instead of the check itself. The sender of that transmission could be a customer, the holder of the check, in which case the creating bank is the depository bank. Alternatively, the sender of that transmission could be a collecting bank, in which case the creating bank is an intermediary bank. Second, the bank to receive the

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<sup>18</sup> U.C.C. § 4-103(b) (2015).

<sup>19</sup> 12 U.S.C. §§ 5001 *et seq.* (2003).

<sup>20</sup> Availability of Funds and Collection of Checks (Regulation CC), 12 C.F.R. § 229 (2015).

<sup>21</sup> *See* 12 U.S.C. § 5001(b)(1) (where an explicit purpose of the Check 21 Act was “[t]o facilitate check truncation by authorizing substitute checks.”)

<sup>22</sup> 12 C.F.R. § 229.51(a).

<sup>23</sup> For a comprehensive overview, though written prior to the promulgation of the final text of 12 C.F.R. § 229.51, *see* PAUL S. TURNER, ANALYSIS OF THE CHECK CLEARING FOR THE 21ST CENTURY ACT (“CHECK 21”) (2004). For more on the background of the Check 21 Act, *see* Availability of Funds and Collection of Checks, 12 C.F.R. § 229, 69 Fed. Reg. 1470 (July 26, 2004) (to be codified at 12 C.F.R. § 229), and Availability of Funds and Collection of Checks, 69 Fed. Reg. 47290 (Oct. 22, 2004) (to be codified at 12 C.F.R. § 229).

substitute check, being either an intermediary bank or the drawee bank, has not agreed to accept electronic transmission of an image, which would be the case for a small bank that does not have the required processing equipment.

Stated otherwise, the Check 21 Act does not require banks to accept electronic transmissions of check information or check images. Rather, it authorizes a collecting bank that agrees to accept the electronic transmission, whether from its customer or a prior collecting bank, to issue a substitute check to be processed onward as if it were the original check. A bank, either a subsequent collecting/intermediary bank or the drawee bank, must accept the substitute check as the equivalent of the original check. By the same token, a customer who has received original checks with the periodic statement showing account activity cannot object to receiving the substitute check in lieu of original checks that have been so truncated in the collection process.<sup>24</sup>

By truncating the paper check, the Check 21 Act eliminates long-distance transport of the physical checks, though the act does not eliminate or bypass intra-city or local check transportation. For example, suppose Drawer has a bank account with Drawee/Payor Bank in New York. Drawer sends a check drawn on that account to Payee in California who in turn deposits the check in their account with a California Depository Bank (Depository Bank). Assume the Depository Bank is a large institution that has equipment necessary for the transmission of the check's image. At the same time, the Payor Bank is a small institution that lacks the processing equipment capable of receiving the electronic transmission of a check. There is nothing within the U.C.C., the Check 21 Act, or anywhere else, to force Payor Bank to accept electronic transmission; hence, electronic presentment is precluded for this transaction. Rather, Depository Bank may transmit the image of the check to an Intermediary Bank in New York, which is capable of accepting such transmissions.<sup>25</sup> In effect, this is an

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<sup>24</sup> See 12 U.S.C. § 5003(a) (an agreement of the recipient is dispensed with for a substitute check deposited, presented, sent for collection, or returned, "so long as a bank has made the warranties in section 5 with respect to such substitute check.")

<sup>25</sup> Interbank settlement between California Depository Bank and New York Intermediary Bank may take various forms. For example, it may be either bilateral (on a correspondent account one bank has with the other), or part of

electronic negotiation of the check. Having agreed to accept the electronic transmission, the New York Intermediary Bank is now required under the Check 21 Act to create a paper substitute check. The Act further requires Payor Bank to accept the presentment of the substitute check as if it were the original check. Finally, any requirement, either by statute or agreement, to provide the canceled check, as under the contract between Drawer and Payor Bank, is to be satisfied under the Check 21 Act by providing the substitute check. In this hypothetical example, coast-to-coast physical transportation was eliminated; only local delivery of the substitute check could not be avoided.

A substitute check is a paper production of the original check that contains the image of the front and back of the original check. It bears a MICR<sup>26</sup> line containing the same information which appears on the MICR line of the original check, and conforms, particularly in paper stock and dimension, to generally applicable standards for substitute checks. As a result, the check is suitable for automated processing in the same manner as the original check.<sup>27</sup> Moreover, a substitute check, to be the legal equivalent of the original, must “accurately represent . . . all of the information on the front and back of the original check as of the time the original check was truncated” and bear the legend “This is a legal copy of your check. You can use it the same way you would use the original check.”<sup>28</sup>

As in the hypothetical above, a substitute check is typically created by a collecting intermediary bank. A substitute check, however, can also be created by the depositary bank when it agrees to receive the deposit of the check from the payee/holder by means of electronic

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multilateral clearing house settlement. If the check is collected through the Reserve Banks, settlement will take place on the books of the Reserve Banks. The Check 21 Act does not deal with interbank settlement arrangements. *See* 12 U.S.C. §§ 5001-5018.

<sup>26</sup> MICR stands for Magnetic Ink Character Recognition Code (MICR Code), which is a character-recognition technology facilitating the automated processing of checks. The code typically includes the document-type indicator, bank code, bank account number, cheque number, cheque amount, and a control indicator. The technology allows MICR readers to scan and read the information directly into a data-collection device.

<sup>27</sup> 12 U.S.C. § 500(16); 12 C.F.R. § 229.2.

<sup>28</sup> 12 U.S.C. § 5003(b)(2); 12 C.F.R. § 229.51(a).

transmission. Furthermore, a substitute check may be created even by the payee/holder. For example, substitute check creation may be desirable for a large organization that receives checks in various locations, but would rather deposit them in one place. The organization may then arrange for the electronic transmission of check images to one place where substitute checks will be created. Alternatively, even an individual may transmit a check image to a depository bank using a mobile device. In general, a check may be transformed from electronic form to substitute checks form several times in the course of the collection and return process.

In connection with a substitute check, the Check 21 Act provides for warranties and an indemnity. The warranties ensure the substitute check meets the requirements for legal equivalence and also protects against double payment on the original check, or any other representation of the check.<sup>29</sup> The indemnity is “to the extent of any loss incurred . . . due to the receipt of a substitute check instead of the original check.”<sup>30</sup> Other than for costs, expenses, and reasonable attorney’s fees, amount to be indemnified is the extent of loss proximately caused by the breach of warranty.<sup>31</sup> In the absence of a breach of a warranty, amount of indemnity is limited to the amount of the substitute check.<sup>32</sup> Either way, amount of loss to be indemnified is reduced by amount representing loss resulting “from the negligence or failure to act in good faith on the part of an indemnified party.”<sup>33</sup> An example of loss incurred notwithstanding the lack of any breach of warranty occurs where forgery, proof of which would have allowed a purported drawer to avoid liability, cannot be proved on the substitute check, but allegedly could have been proved on the original. Thus, on occasion, an effective method to determine the authenticity of a manual signature could be by measuring the pen pressure input by the signer.<sup>34</sup> This feature does not carry over to the copy of the check and certainly not to a substitute check created from the image of the check.

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<sup>29</sup> 12 U.S.C. § 5004 (2003); 12 C.F.R. § 229.52(a).

<sup>30</sup> 12 U.S.C. § 5005(a).

<sup>31</sup> 12 U.S.C. § 5005(b)(1).

<sup>32</sup> 12 U.S.C. § 5005(b)(2).

<sup>33</sup> 12 U.S.C. § 5005(c) (2003); *see also* 12 C.F.R. § 229.53 (2015).

<sup>34</sup> *See e.g.*, PAUL S. TURNER, *supra* note 23, at 26.

Substitute check warranties are given by each bank “that transfers, presents, or returns a substitute check and receives consideration for the check.”<sup>35</sup> A “reconverting bank” is not listed. Being the bank that creates the substitute check or, where the substitute check is created by the depositor, the first bank that transfers or presents the substitute check, this bank can hardly be described as a bank that transfers a substitute check, unless “transfer” is to include the first delivery or issue. This indeed appears to be the view of the Federal Reserve.

In turn, indemnity liability is incurred by “[a] reconverting bank and each bank that subsequently transfers, presents, or returns a substitute check in any electronic or paper form, and receives consideration for such transfer, presentment, or return.”<sup>36</sup> Accordingly, the reconverting bank is listed as one to become liable to indemnify for loss caused by the breach of warranty.

As indicated, a substitute check need not necessarily be created by a bank; rather it may be created by a person other than a bank, typically a large organization-payee. In such a cases, under the Check 21 Act, warranties and indemnity liability originate from not from either payee or the creator of the substitute check, but rather from the first bank that transfers or presents such substitute check; such a bank, being the depositary bank, is then considered to be the “reconverting bank” in the collection process.

Both substitute check warranties and the indemnity are stated to run to the benefit of the transferee, any subsequent collecting or returning bank, the depositary bank, the drawee, the drawer, the payee, the depositor, and any endorser.<sup>37</sup> Since a check can be transformed from electronic form to substitute check form several times in the course of the collection and return process, it is possible that there could be multiple substitute checks, and thus multiple reconverting banks, with respect to the same payment transaction. A subsequent participant may thus benefit from warranties and indemnity of more than one reconverting bank. As well, a collecting bank receiving an electronic representation of a substitute (rather than original) check

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<sup>35</sup> 12 U.S.C. § 5004.

<sup>36</sup> 12 U.S.C. § 5004-5005; *see also* 12 C.F.R. §§ 229.52, 229.53.

<sup>37</sup> 12 U.S.C. §§ 5004-5005.

will both receive and pass on the reconverting bank's Check 21 Act warranty and indemnity protections.

The Check 21 Act further contains provisions covering expedited re-credit for consumers and banks. First, Section seven permits a consumer to challenge a debit for a substitute check either where the check was not properly charged to the consumer's account or where the consumer has a warranty claim.<sup>38</sup> In each case, the consumer must have suffered a resulting loss, and the production of the original check or a better copy of it is necessary to determine the validity of the challenge or claim. Second, Section eight governs a claim by a bank that is obligated to provide an expedited re-credit to the consumer or that has otherwise suffered loss in circumstances where "production of the original check . . . or a better copy of [it] is necessary to determine the validity of the charge to the customer account or any warranty claim connected with such substitute check."<sup>39</sup> The claim is a claim for indemnity from another bank that incurred the indemnity liability to the claimant bank under Section eight.<sup>40</sup>

The Check 21 Act allocates losses only among banks that handle a substitute check. However, it is possible that the problem giving rise to liability under the Check 21 Act was created prior to the creation of a substitute check. For example, electronic information derived from the check may have consisted of a poor image of the original check. This would preclude the reconverting bank from creating a legally equivalent check and thus cause it to be in breach of a substitute check warranty. Otherwise, a substitute check created by the payee and deposited at the depository bank may have been deficient in one way or another. At the same time, neither warranties nor indemnity liabilities are provided in the Check 21 Act in connection with the electronic transmission of check image or information. Similarly, no warranties or indemnity liability are fastened on a payee who creates a substitute check. Responsibilities of transmitters of electronic information and depositors of substitute checks are thus to be provided by their respective contracts with the immediate recipients of electronic information and substitute checks. This is consistent with

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<sup>38</sup> 12 U.S.C. § 5006.

<sup>39</sup> 12 U.S.C. § 5007(a)(1)(D).

<sup>40</sup> See 12 C.F.R. §§ 229.54-.55 (corresponding to and implementing 12 U.S.C. §§ 5006-5007).

the overall position under the Check 21 Act, under which no bank is required to receive electronic transmission of check data and no depositary bank is required to accept the deposit of substitute checks. Having nevertheless agreed to accept such information or substitute checks, it is up to the collecting banks to execute their contractual obligations.

Contract, however, is not the exclusive source of regulating responsibilities outside the Check 21 Act. Under Regulation J, a sender of an electronic item derived directly from the original check makes two sets of warranties for the electronic item. First, the sender makes transfer warranties as if the item was a paper check governed by the U.C.C. Second, the sender makes warranties as if the item were a substitute check governed by the Check 21 Act.<sup>41</sup> For checks handled by Reserve Banks governed by Regulation J, an end-to-end combined U.C.C and Check 21 liability structure is thus provided.<sup>42</sup>

#### IV. INTERBANK EXCHANGE OF CHECK IMAGES

The Check 21 Act<sup>43</sup> does not provide rules to govern image exchange, inter-bank electronic negotiation, or electronic presentment or return. Rather, the Check 21 Act requires a collecting bank that agrees to accept the electronic transmission, whether from its customer or a prior collecting bank, to issue a substitute check to be processed onward as if it were the original check.

A bank's authority to accept an electronic check transaction derives from the U.C.C. As indicated, under U.C.C Section 4-110 (b), "[p]resentment of an item pursuant to an agreement for presentment is made when the presentment notice is received." Under U.C.C Section 4-110(a), "Agreement for electronic presentment" is defined to mean "an agreement, clearing-house rule, or Federal Reserve regulation or operating circular, providing that presentment of an item may be made by transmission of an image of an item or information describing the item ("presentment notice")." While this is limited to

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<sup>41</sup> See Collection of Checks and Other Items by Federal Reserve Banks and Fund Transfers Through Fedwire, 12 C.F.R. §§ 210.2, 210.6, 210.12 (2015).

<sup>42</sup> For background see 12 C.F.R. 210 (2015).

<sup>43</sup> 12 U.S.C. § 5001 *et seq.*



the electronic presentment of checks, U.C.C. Section 4-103(a) is broader. Thereunder, in general and subject to limitations relating to disclaimer clauses, “[t]he effect of the provisions of . . . Article [4] may be varied by agreement.” While such agreements bind only those who are parties to them, under U.C.C. Section 4-103(b), “Federal Reserve regulations and operating circulars, clearing-house rules, and the like have the effect of agreements under subsection (a), whether or not specifically assented to by all parties interested in items handled.” “Clearing house” is defined in Section 4-104(a)(4) as “an association of banks or other payors regularly clearing items.” Accordingly, bilateral and multilateral agreements, clearing house rules, and Federal Reserve regulations and operating circulars may govern the exchange, namely the interbank negotiation presentment and return of check images or information relating to them, as substitutes to physical delivery.

In practice, there are two principal sets of image exchange rules. Essentially, both endeavor to equate the position of check images to that of the checks themselves under existing legislation and other sources of law. In fact, they extend the legal framework of the Check 21 Act<sup>44</sup> to cover image exchanges. The first set of image exchange rules is Subpart A of Regulation J governing interbank exchange through Federal Reserve Banks.<sup>45</sup> Further implemented by Operating Circular No. 3, it specifically deals with the collection of checks and other items by Federal Reserve Banks. Thereunder, an “item” is broadly defined to cover an electronic image of a paper check.<sup>46</sup> The second is Electronic Check Clearinghouse Organization (ECCHO) Operating Rules.

ECCHO<sup>47</sup> is “a national not-for-profit ‘rule-making organization’ owned entirely by its member banks.”<sup>48</sup> As “an

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<sup>44</sup> 12 U.S.C. §§ 5001 *et seq.* (2003).

<sup>45</sup> 12 C.F.R. § 210.

<sup>46</sup> 12 C.F.R. § 210.2(i)(1)(ii).

<sup>47</sup> See ELECTRONIC CHECK CLEARING HOUSE ORGANIZATION, RULES SUMMARY (2012); see also *Membership Overview*, ECCHO, <http://www.eccho.org/membership> (last visited Oct. 18, 2015); see also VIVECA Y. WARE, CHECK IMAGE EXCHANGE: COVERING LEGAL BASES (2008).

<sup>48</sup> Alvin C. Harrell, *Electronic Checks*, 55 CONSUMER FIN. L.Q. REP. 283 (2001).

association of banks or other payors regularly clearing items,” ECCHO is a clearing house under U.C.C Section 4-104(a)(4). This is so even though ECCHO does not process payments. Rather, ECCHO develops rules governing electronic exchanges of check images. Such rules qualify as “clearing-house rules” under U.C.C Section 4-103(b), which govern bilateral and multilateral exchanges of member banks that choose to adhere to them. Per that provision, “all parties interested in [the checks]” are bound by such rules governing their exchange.<sup>49</sup>

ECCHO was established in 1990. It is common knowledge that the primary drive behind its establishment was to address the increased risk resulting from the introduction of tight funds availability schedules for checks under Regulation CC.<sup>50</sup> The use of electronics expedited both the forward presentment and return processes so as to allow banks to meet the statutory tight schedules.

ECCHO has four membership classes: Full Members, Affiliate Members, Participating Members, and Sponsored Members. The different classes reflect variations in Members’ roles in the corporate governance of the organization. A Member must establish the technological and communication methods for exchanging electronic check transactions with another Member.

ECCHO Rules apply to the interbank exchange, by negotiation or presentment, of check images. ECCHO Rules do not, however, apply to the substitute checks that reproduce check images. Substitute checks, and to some extent, images of substitute checks, are governed by Check 21 Act<sup>51</sup> and provisions of Regulation CC<sup>52</sup> implementing it. ECCHO Rules govern only electronic check transactions between two Members. A Member is not required, by virtue of its membership, to send and receive electronic check transactions with another Member. Member agreements may designate a particular electronic communication switch or a check image archive to exchange electronic check images and are outside the ECCHO framework. While

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<sup>49</sup> U.C.C. § 4-103(b) (2015).

<sup>50</sup> Availability of Funds and Collection of Checks (Regulation CC), 12 C.F.R. § 229 (2015).

<sup>51</sup> 12 U.S.C. §§ 5001 *et seq.* (2003).

<sup>52</sup> 12 C.F.R. § 229.

supporting a number of processes for check image exchange, ECCHO Rules do not establish the rules for accessing or using private networks/archives. Members may thus exchange electronic check transactions in whatever way they choose. On occasion, two networks may agree to establish a “bridge” or link to facilitate an exchange between sending and receiving Members each using a separate network.

A Member which agreed with another Member to exchange electronic check transactions under ECCHO Rules is bound to comply with ECCHO Rules. These Rules do not constitute customer agreements, but they bind customers by virtue of U.C.C Section 4-103(b).

ECCHO Rules provide for the legal framework for both forward check image presentment and return of a check image. In a forward check image presentment, both the Electronic Image and the related MICR line information are sent<sup>53</sup> or made available to the receiving Member by an applicable deadline. The check itself is not sent to the receiving Member. Under ECCHO Rules, the Electronic Image is an “item” as well as “check” under the U.C.C and Regulation CC.<sup>54</sup> ECCHO Rules also provide for the time presentment is actually made and further address diverse matters such as indorsements and storage and retrieval of the original check.<sup>55</sup> To protect the receiving Member in each electronic check transaction, ECCHO Rules provide for indemnifications and warranties, some of which are in addition to those provided under the U.C.C and Regulation CC.<sup>56</sup> Particularly, these warranties relate to the compliance with ECCHO Rules as well as the accuracy and quality of the Electronic Image.

An important warranty given by a sending bank is a warranty against double payment. This warranty is originated by the first bank

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<sup>53</sup> For transmission of an electronic image of a check via wire communication, albeit to a Federal Reserve Bank, *see, e.g., United States v. Jinian*, 712 F.3d 1255, 1259 (9th Cir. 2013).

<sup>54</sup> 12 C.F.R. § 229.

<sup>55</sup> ELECTRONIC CHECK CLEARING HOUSE ORGANIZATION, OPERATING RULES AND COMMENTARY (2014).

<sup>56</sup> *Id.*

that transferred an image. A bank may mistakenly send the same image more than once. Where the first image is created by the depositor, a few alternative scenarios may develop as the result of either error or fraud. The holder may send an image of the check for deposit more than once, and may not send it to the same bank. Alternatively the holder may send the image of the check for deposit to a bank and then negotiate the paper check to a subsequent holder. Practically, the latter may be a check cashing service, or even another depository bank. The chance is that any subsequent holder, including a depository bank which took either the paper check or an electronic image of it, will be a holder in due course.<sup>57</sup>

The warranty given by the bank that originated the image is designed to protect the payor bank in all such scenarios. Thus, a payor bank that paid twice may not be able to debit the drawer-customer's account more than once and will recover on the aforesaid warranty. The Paying Bank is only required to establish the existence of a double payment for the same item and that the Paying Bank incurred a loss as a result. ECCHO Rules do not provide for a warranty or any other responsibility on a depositor who remotely deposited the check by capturing its image and sending it to the depository bank. It is up to the latter to provide for a recourse against the capturing depositor in its customer agreement.

The application of the warranty against double payment in the context of a holder in due course is consistent with and furthers the general underlying policy as expressed in the warranty provisions of the Check 21 Act,<sup>58</sup> Regulation CC<sup>59</sup> provisions applicable to substitute checks, and the ECCHO Rules. This policy aims at protecting the payor bank and drawer customer from losses associated with double payment of a check image or substitute check. Moreover, where the first image was created by the depositor, it is appropriate for the depository bank to bear risk of loss from any resulting double payment. This is so because the bank that transferred the first check image introduced the risk of double payment into the system by allowing its customer to engage in remote deposit capture.

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<sup>57</sup> U.C.C. §§ 3-302, 4-211.

<sup>58</sup> 12 U.S.C. §§ 5001 *et seq.* (2003).

<sup>59</sup> 12 C.F.R. § 229.

Under a proposal of the Board from 2013,<sup>60</sup> and unless otherwise agreed by the sending and receiving banks,<sup>61</sup> electronic images of checks and electronic information related to checks that banks send and receive by agreement would be subject to Subpart C of Regulation CC as if they were paper checks. Under the earlier version of the Proposal from 2011, the object of each such electronic transmission was called “electronic collection item” or, in the case of returning it dishonored, “electronic return.” The 2013 Proposal preferred to rename them “electronic check” and “electronic return check,” respectively.<sup>62</sup> In departure from the 2011 version, under the 2013 Proposal, electronic checks and electronic returned checks could consist of either check electronic image or check electronic information, and not necessarily both.<sup>63</sup>

Since under proposed Section 229.30(a)<sup>64</sup> electronic checks and electronic returned checks are subject to the provisions of subpart C as if they are checks, a bank that handles them gives all checks warranties and indemnities.<sup>65</sup> Proposed §229.34(a) will provide for additional “Check-21-like warranties”<sup>66</sup> specifically given with respect to electronic checks and electronic returns. Under proposed §229.34(a)(1), each bank that transfers or presents an electronic check

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<sup>60</sup> Availability of Funds and Collection of Checks, 79 Fed. Reg. 6673-6737 (Feb. 4, 2014) (to be codified at 12 C.F.R. 229) [hereinafter FRS Availability Proposal].

<sup>61</sup> In 12 C.F.R. § 229.37(a), the FRS Availability Proposal would permit a sending and receiving bank by agreement to vary the warranties the sending bank makes to the receiving bank for electronic checks and electronic returned checks. Such an agreement could provide, for example, that the bank transferring the electronic check does not warrant that the electronic image or information are sufficient to create a substitute check. The agreement would not, however, vary the effect of the warranties with respect to banks and persons not bound by the agreement. *Id.* at 6684.

<sup>62</sup> Availability of Funds and Collection of Checks, 76 Fed. Reg. 16862 (Mar. 25, 2011) (to be codified at 12 C.F.R. § 279).

<sup>63</sup> See FRS Availability Proposal, *supra* note 60.

<sup>64</sup> *Id.*

<sup>65</sup> See Availability of Funds and Collection of Checks (Regulation CC), 12 C.F.R. §229.34(d)-(f) (2015) (warranties relating to (i) settlement amount, encoding, and offset; (ii) returned checks; and (iii) notice of nonpayment).

<sup>66</sup> See FRS Availability Proposal, *supra* note 60 at 6683.

or electronic returned check and receives a settlement or other consideration for it warrants that:

- (i) The electronic image accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated and the electronic information contains an accurate record of all MICR line information required for a substitute check . . . and the amount of the check, and
- (ii) No person will receive a transfer, presentment, or return of, or otherwise be charged for an electronic check or electronic returned check, the original check, a substitute check, or a paper or electronic representation of a substitute check such that the person will be asked to make payment based on a check it has already paid.<sup>67</sup>

This is a double warranty for (i) the accuracy and completeness of the electronic record, and (ii) double payment of the check. Under paragraph 2, the beneficiary of the double warranty, is:

- (i) In the case of transfers for collection or presentment, the transferee bank, any collecting bank, the paying bank, and the drawer; and
- (ii) In the case of transfers for return, the transferee returning bank, any subsequent returning bank, the depositary bank, and the owner.<sup>68</sup>

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<sup>67</sup> See *id.* at § 229.34(a)(1).

<sup>68</sup> See *id.* (Board requested comment on whether the drawer under sub-paragraph (i) or owner under sub-paragraph (ii) should be required to make a claim against his or her bank before making a breach of warranty claim against a prior collecting bank.).

Under proposed §229.34(g), an additional indemnity is given in the case of a remote deposit capture, namely where an electronic check is created by the depositor. This indemnity inures to the benefit of a depositary bank to which the depositor, having deposited the electronic check, deposited the original paper check with another depositary bank. In such a case, an indemnity is given by a depositary bank which “(i) [i]s a truncating bank under § 229.2(eee)(2) because it accepts deposit of an electronic check related to an original check; (ii) [d]oes not receive the original check; (iii) [r]eceives settlement or other consideration for an electronic check or substitute check related to the original check; and (iv) [d]oes not receive a return of the check unpaid.”<sup>69</sup> Such a depositary bank shall indemnify a depositary bank that accepts the original check for deposit for losses incurred by that depositary bank if the loss is due to the check having already been paid.

The indemnity would allow a depositary bank that accepted a deposit of an original (paper) check to recover directly from a bank that permitted its customer to deposit the check through remote deposit capture.

Under proposed §229.34(i)(1), the indemnity amount shall not exceed the sum of—

- (i) The amount of the loss of the indemnified bank, up to the amount of the settlement or other consideration received by the indemnifying bank; and
- (ii) Interest and expenses of the indemnified bank (including costs and reasonable attorney’s fees and other expenses of representation).<sup>70</sup>

However, under proposed §229.34(i)(2)(i), and without reducing “the rights of a person under the UCC or other applicable provision of state or federal law,”<sup>71</sup> if such loss

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<sup>69</sup> See *id.*

<sup>70</sup> See *id.*

<sup>71</sup> See *id.* at §229.34(i)(2)(ii).

results in whole or in part from the indemnified bank's negligence or failure to act in good faith, then the indemnity amount . . . shall be reduced in proportion to the amount of negligence or bad faith attributable to the indemnified bank.<sup>72</sup>

In its Commentary to the Proposal, the Board rationalized the allocation of the double deposit risk to the truncating bank as follows:

[T]he depositary bank that introduced the risk of multiple deposits of the same check by offering a remote deposit capture service should bear the losses associated with multiple deposits of a check. A depositary bank that receives the benefit of permitting its customers to use remote deposit capture should also internalize any risk or cost to other banks that may result from remote deposit capture. One such risk is that the customer will deposit the original check at another bank. That bank that accepted the check by remote deposit capture is in a better position than any other bank to minimize those costs and risks through the terms of its contract with its customer.<sup>73</sup>

At the same time, the Board requested comments on unintended consequences that might result from the indemnity as well as “on whether the depositary bank that accepts the original check for deposit would be able to identify the depositary banks against which it may bring a claim for indemnity . . . and whether there are other more efficient or practical remedies to address the underlying problem.”<sup>74</sup> However, no remedy is provided in the case of multiple electronic checks created by a depositor related from the same paper check.

It should be noted that, under the U.C.C., a bank that receives an electronic deposit of a check may arguably be able to control the risks of multiple deposits and negotiation of the paper check to a

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 6685.

<sup>74</sup> *Id.*



holder in due course by having the negotiability of the check curtailed.<sup>75</sup> Thus, U.C.C Section 3-104(d) effectively provides<sup>76</sup> that:

a check is [a negotiable instrument even] if, at the time it is issued. . . , it contains a conspicuous statement, however expressed, to the effect that the promise or order is not negotiable or is not an instrument governed by this Article.<sup>77</sup>

This language does not appear to preclude a requirement made by a bank receiving an electronic deposit to have the check marked as “non-negotiable” or some other language to that effect at the time of the deposit (as opposed to the time of its issue). Such marking may even preclude a competing depositary bank from claiming a holder in due course status to the extent that U.C.C Section 4-205 protects a depositary bank claiming a holder in due course status only against the lack of indorsement but not otherwise.<sup>78</sup>

A more limited protection appears to be offered under U.C.C Section 4-201(b), providing that once an item has been indorsed with words such as “pay any bank,” “only a bank may acquire the rights of

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<sup>75</sup> For the holder in due course and the holder in due course power to defeat competing claims to the instrument, *see* U.C.C. §§ 3-302, 305, 306 (2015).

<sup>76</sup> The provision reads in full as follows: “A promise or order other than a check is not [a negotiable instrument] if, at the time it is issued or first comes into possession of a holder, it contains a conspicuous statement, however expressed, to the effect that the promise or order is not negotiable or is not an instrument governed by this Article.”

<sup>77</sup> U.C.C. § 3-104 (2015).

<sup>78</sup> *See* U.C.C. § 4-205 (2015) (stating that “[i]f a customer delivers an item to a depositary bank for collection: (1) the depositary bank becomes a holder of the item at the time it receives the item for collection if the customer at the time of delivery was a holder of the item, whether or not the customer indorses the item, and, if the bank satisfies the other requirements of U.C.C. § 3-302 (2015), it is a holder in due course.”); *see also* U.C.C Section 4-104(a)(9) (2015) (where “item” is defined as “[a negotiable] instrument or a promise or order to pay money handled by a bank for collection or payment”). While an item need not necessarily be “negotiable,” under U.C.C § 3-302, a holder in due course may exist only in connection with a negotiable instrument.

a holder”<sup>79</sup> so as to be able to defeat an adverse claim by a non-bank, albeit not necessarily by a competing depository bank. However, along these lines, protection expands and becomes maximal under U.C.C. Section 3-206(c) covering a check bearing:

an indorsement (i) described in Section 4-201(b), or (ii) in blank or to a particular bank using the words “for deposit,” “for collection,” or other words indicating a purpose of having the instrument collected by a bank for the indorser or for a particular account . . . .<sup>80</sup>

In this case, Section 3-206(c) states:

- (1) A person, other than a bank, who purchases the instrument when so indorsed converts the instrument unless the amount paid for the instrument is received by the indorser or applied consistently with the indorsement.
- (2) A depository bank that purchases the instrument or takes it for collection when so indorsed converts the instrument unless the amount paid by the bank with respect to the instrument is received by the indorser or applied consistently with the indorsement.<sup>81</sup>

Effectively, this means that to achieve maximum protection,<sup>82</sup> and notwithstanding the fact that from a business perspective this may

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<sup>79</sup> See U.C.C. § 4-201(b) (2015) (where this is so, until the item has been: “(1) returned to the customer initiating collection; or (2) specially indorsed by a bank to a person who is not a bank.”)

<sup>80</sup> U.C.C. § 3-206(c) (2015).

<sup>81</sup> *Id.*

<sup>82</sup> Having transmitted to Bank A an image of a check indorsed to Bank A, a defrauding depositor may erase the indorsement, indorse the check to Bank B (or to non-bank C), and transmit the image for deposit to Bank B (or negotiate the paper check to non-bank C). I would argue that in such a case, the defrauding customer effectively either forged the holder’s indorsement on the check or altered the check in which the starting point for the discussion on the loss allocation is either U.C.C. §§ 3-403 or 3-407 (2015).

be unappealing, a depository bank would be advised to accept electronic deposit only of images of checks indorsed specifically to it.

#### V. ELECTRONIC PAYMENT ORDER (EPO) AS “PAPERLESS CHECK”<sup>83</sup>

So far, the electrification of check transaction has been discussed as it relates either to the issue of a check on the basis of the issue of electronic instruction, or to the “conversion,” deposit, interbank negotiation, and presentment of the check. Other than inter-party negotiation outside the bank collection system for which, so far, no strong business case has been made, the “last mile” in check electrification is concerned with the elimination of paper as early as on the issue of the “check.” This is feasible technologically and efficient economically; it is indeed said that the EPO possesses features such as “speed, finality, relatively low cost, and ubiquity.”<sup>84</sup> At the same time, from a legal perspective, the legal features of the EPO are not entirely clear. Particularly, strictly speaking, this payment method is not a “check” as it does not involve anything tangible in writing. Indeed, check truncation in all its forms is premised on an image as well as a substitute check as derivations of a paper check issued by the drawer to the payee (or bearer).

In the absence of a statutory or otherwise precise definition, broadly speaking, an electronically issued payment order, with all other characteristics of a check, which is treated as a ‘paperless check’ is known as an EPO. Like a paper check,<sup>85</sup> an EPO is typically issued by the drawer/payer and is addressed to the drawee/payor bank, ordering the payor bank to pay on demand a sum certain in money to the payee (or bearer) to whom the order is issued. As with a paper check, an EPO may be issued on behalf of the drawer by the payee or at the drawer’s

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<sup>83</sup> See, e.g., KATY JACOB ET AL., FEDERAL RESERVE BANK OF CHICAGO: FINANCIAL MARKETS GROUP, DIGITAL CHECKS AS ELECTRONIC PAYMENT ORDERS (2009); see also MARY KEPLER, RETAIL PAYMENTS RISK FORUM, A SUMMARY OF THE ELECTRONIC PAYMENT ORDER FORUM (2013); see also PHYLLIS MEYERSON, ELECTRONIC PAYMENT ORDERS (EPOs) (2013). The discussion in this subsection draws on these sources.

<sup>84</sup> See generally KEPLER, *supra* note 83.

<sup>85</sup> “Paper-check,” as defined in U.C.C. § 3-104(f) (2015), in conjunction with U.C.C. §§ 3-103(a)(8) and 3-104(e) (2015), is used in this section in the sense of a “check” to distinguish it from the EPO.

instruction by the bank itself. In the former case it is the equivalent of either a Remotely Created Check (RCC), or even an electronic check. In the latter case, when issued by the drawer's bank, it is the equivalent of a cashier's check or a teller's check.<sup>86</sup>

An EPO generated from a mobile device such as a mobile phone is also referred to as a "digital check." It is issued under a banking application which exploits the computing properties of the mobile platform to provide built-in authentication, communications, and security for electronic check writers. Thus, an account holder who wishes to make payment may use his or her mobile device to issue a "digital check." He or she may access the address book on the mobile device for a list of potential payees. The list can be updated by the account holder using the mobile device at any time. The account holder then sets out the amount of the "check" and the date, and then *physically* 'signs' on the screen as if he or she signs manually on a piece of paper. As a security safeguard, the pressure and speed the writer uses in making the signature can be recorded for the transaction. This "improves" on the loss of the ability to determine pen pressure in images and, in the case of substitute checks, prevents disputes as to the authenticity of the payment instructions. A proposed complementary security method is that of a national check registry.<sup>87</sup>

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<sup>86</sup> See U.C.C. § 3-104(g) (2015) (a "[c]ashier's check" means a draft with respect to which the drawer and drawee are the same bank or branches of the same bank."). A "[t]eller's check" means a draft drawn by a bank (i) on another bank, or (ii) payable at or through a bank." Effectively, a cashier's check as well as a teller's check is a check drawn by a bank.

<sup>87</sup> *Id.* ("Such a national registry would have been totally impractical to implement in an all-paper environment, but would be relatively straightforward in a digital environment. Given a national registry operating as a utility, EPO users could download blank check images from the national check registry. As EPOs were processed and cleared through the banking system, the existence of each item could be verified in the national registry. Each device could obviously have its own internal check registry for each separate account. As items cleared against an individual account, the update would be reflected on the internal registry so account holders would have an up-to-date picture of their account balances. In addition to helping with budgeting and self-control issues, this concurrent information would also be useful to detect potential fraud." JACOB, *supra* note 67, at 15-16. However, the authors add a warning: "While straight forward conceptually, a national registry [being 'organized as a top-down utility'] could end up being a roadblock to enhanced security over time.")

The software check program then creates a visual image of both the front and the back of the “check,” and takes a screen shot of the image. The program then transmits an encrypted version of the imaged “check” (to which the “handwritten” signature is attached) to the payee who will then deposit it electronically to his or her account with the depository bank. In principle, there is no preclusion from devising a scheme that will allow the electronic negotiation of the “check” outside the banking system prior to its deposit by the last non-bank holder.

Arguably, so far as payments out of consumer accounts are concerned, the Electronic Fund Transfer Act<sup>88</sup> and Regulation E<sup>89</sup> implementing it would govern the relationship between the drawer and the drawee bank.<sup>90</sup> In the absence of an existing comprehensive statutory and regulatory framework, private agreements are required to fill the gap and determine legal issues involving the EPO. A natural inclination is to resort to the U.C.C. and the Check 21 Act. Briefly stated, two caveats are to be mentioned. First, both U.C.C. Articles 3 and 4 envisage paper documents and as such cannot be made to apply mechanically on a wholesale basis. Second, since there is no paper item to begin with, Article 4 does not apply on its own force as a statute. Accordingly, Section 4-103(b), under which “Federal Reserve regulations and operating circulars, clearing-house rules, and the like have the effect of agreements . . . whether or not specifically assented to by all parties interested in items handled,” cannot be relied upon to affect “parties interested in items handled” who have “not specifically assented to” them.<sup>91</sup>

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<sup>88</sup> 15 U.S.C. § 1693 *et seq.* (2010).

<sup>89</sup> Electronic Fund Transfers, 12 C.F.R. § 205 (2015).

<sup>90</sup> *See generally* 12 C.F.R. § 205.3; *see also* 12 C.F.R. § 205.3(b) (“The term electronic fund transfer [to which the Regulation applies] means any transfer of funds that is initiated through an electronic terminal, telephone, computer, or magnetic tape for the purpose of ordering, instructing, or authorizing a financial institution to debit or credit a consumer’s account.”); *see also* 12 C.F.R. § 205.2(e) (Enumerated non-exclusive example focus on public access terminals. “Consumer” is defined as “a natural person.”).

<sup>91</sup> U.C.C. § 4-103(b) (2015).

Purporting to address the collection of EPOs,<sup>92</sup> the Federal Reserve Board (“Board”) noted that not being derived from an original paper check, an electronically-created check image cannot be used to create a substitute check that meets the requirements of the Check 21 Act and Regulation CC. The Board, however, observed that as a practical matter a collecting bank receiving an electronically-created check image cannot distinguish it from an image of a paper check that it receives electronically. The bank may transfer the image as if it were derived from a paper check, or produce a paper item that is indistinguishable from a substitute check. Under a proposed revision to Section 229.34 of Regulation CC, the Board proposed that a bank that transfers an image in the collection system would make all warranties the bank would make if the image were derived from a paper check. By the same token, such an image could be the basis from which a valid substitute paper check be created.

In addition, under the proposal a bank receiving a warranty claim related to an electronic collection item, electronic return, or a nonconforming substitute check would be able to pass back its liability for the item to the bank from which it had received the electronically-created image and information. Recognizing that in some instances the first bank to make the warranty may not know whether an image and information came from a paper instrument, the Board nevertheless expressed its view that that bank is in the best position to know and to protect itself contractually against the risk.

Accordingly, under the Board’s 2013 Availability Proposal,<sup>93</sup> proposed Section 229.34(b) provides for an indemnity with respect to an electronic image or electronic information not related to a paper check. It covers situations where either the drawer or the payee under the drawer’s authority creates an electronic image. The latter case may be referred to as an eRCC.<sup>94</sup> Under proposed Section 229.34(b):

Each bank that transfers or presents an electronic image or electronic information that is not derived

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<sup>92</sup> Availability of Funds and Collection of Checks, 76 Fed. Reg. 16862 (March 25, 2011) (to be codified at 12 C.F.R. 229); *see also* FRS Availability Proposal, *supra* note 60.

<sup>93</sup> Availability of Funds and Collection of Checks, *supra* note 92.

<sup>94</sup> eRCC stands for a Remotely Created Electronic Check.

from a paper check and for which it receives a settlement or other consideration shall indemnify each transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against losses as set forth in paragraph (i) of this section that result from the fact that the electronic image or electronic information is not derived from a paper check.<sup>95</sup>

Presumably, the reference is to Proposed Section 229.34(a)(1)(i) under which the warranty given with respect to electronic checks and electronic returns is that:

The electronic image accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated and the electronic information contains an accurate record of all MICR line information required for a substitute check . . . and the amount of the check.<sup>96</sup>

As explained in the Commentary to the Proposal:

Proposed § 229.34(b) would provide that a bank that transfers an electronic image or electronic information that is not derived from a paper check indemnify the transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against any loss, claim, or damage that results from the fact that the image or information was not derived from a paper check. This proposed indemnity would protect a bank that receives an electronically-created item from a sending bank against any loss or damage that results from the fact that there was no original check corresponding to the item that the sending bank transferred.<sup>97</sup>

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<sup>95</sup> See FRS Availability Proposal, *supra* note 60.

<sup>96</sup> *Id.*

<sup>97</sup> See *id.* at 6695.

In particular, this purports to cover all losses caused by warranty breaches had the electronically-created item been derived from a paper check. It also covers losses caused by the absence of paper at any stage of the life of the payment item, a fact of which the drawee bank may be unaware.

The indemnity under proposed Section 229.34(b) would not flow to the drawer, payee, or the depository bank. The Board rationalized that “the payee and the depository bank are in the best position to know whether an item is electronically created and to prevent the item from entering the check collection system.”<sup>98</sup> The Board went on to explain that the depository bank can contractually pass the risk to the payee. Finally, it is the drawer who introduced “items electronically created by the [drawer]” into the check collection system.<sup>99</sup> At the same time, had the item been introduced as an eRCC without the purported drawer’s authority, the latter will be protected under U.C.C 4-401(a) as an item which is not “properly payable.”

Under proposed Section 229.34(i)(1) the indemnity amount shall not exceed the sum of:

- (i) The amount of the loss of the indemnified bank, up to the amount of the settlement or other consideration received by the indemnifying bank; and
- (ii) Interest and expenses of the indemnified bank (including costs and reasonable attorney’s fees and other expenses of representation).

However, under proposed Section 229.34(i)(2)(i), and without reducing “the rights of a person under the UCC or other applicable provision of state or federal law” if such loss “results in whole or in part from the indemnified bank’s negligence or failure to act in good faith, then the indemnity amount . . . shall be reduced in proportion to the amount of negligence or bad faith attributable to the indemnified bank.”<sup>100</sup> The Board requested comment on its proposal to provide an

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<sup>98</sup> See *id.*

<sup>99</sup> *Id.* at 6696.

<sup>100</sup> See *id.* at § 229.34(i)(2)(ii).



indemnity claim related to electronically-created items instead of extending the check warranties of § 229.34 to electronically-created items.<sup>101</sup>

#### CONCLUDING OBSERVATIONS

Wishing to accommodate both manual and electronic handling of checks by the various participants in a check transaction, regulators have been providing for an extremely flexible scheme covering diverse situations and facilitating maximum freedom of movement between paper and image, original and copy. However, an environment in which one set of rights and duties is embodied in original paper, its copy, and its electronic image, all of which co-exist, albeit not necessarily in the same hands, is quite unsafe, as it may lead to conflicting claims to the paper and its image. It is bound to create an ‘explosive’ mixture leading to conflicting legitimate expectations. To minimize surprises, rules are to be detailed. At the same time they cannot satisfy every innocent party in the check transaction.

In the final analysis, a move towards complete electronification from end to end seems to be appropriate in the electronic age and is to be encouraged. A fully electronic check transaction is interchangeable with a one-time electronic debit transfer. In the latter, the payor authorizes the payee to draw funds out of the payor’s account. The issuance of an EPO to the payee serves the same purpose. It is obvious then that the two transactions converge. From that perspective, the convergence between the laws that govern those transactions ought to be seriously considered. A cohesive forward-looking legal framework, consisting of statutory, regulatory, and contractual sources, ought to address debit transfers as a distinct form of payment. This is true even if in response to business demands a mixed paper and electronic image environment is still to be accommodated, at least for some time. Indeed, Articles 3 and 4 of the Uniform Commercial Code provide a comprehensive framework governing the payment and collection of paper based debit instruments. At the same time consideration is to be given to the

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<sup>101</sup> *Id.* at 6684 (the Board further requested comment on whether losses proximately caused from not being able to make the warranty claim should be interpreted to cover damages awarded for violations of Regulation E).

drafting of a new Article 3A of the Uniform Commercial Code to form a comprehensive piece of legislation governing electronic debit transfers including the electronic cheque transaction. The current mixture of state and federal laws as well as private agreement is too segmented to guaranty a sound evolution of the law to address forthcoming innovations and the new issues they raise.